Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:SD:TL-N-7216-99
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date: JAN 03 2000

to: Examination Division, Laguna Niguel
ATTN: Randy Mita, International Examiner, SP:1413

from: Associate District Counsel, Southern California District, San Diego

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subject: [redacted]

Imputed Interest on Accounts Payable Pursuant to I.R.C. § 482

This memorandum responds to your request for advice regarding whether, for the taxable years ending March 31, [redacted] through March 31, [redacted] and the short-year ending December 31, [redacted], the Service should impute interest pursuant to section 482[1] on "overaged" accounts payable due from [redacted] (the "Taxpayer") to its parent and affiliated companies.

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

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[1] All section references are to the Internal Revenue Code in effect for the tax years in issue, unless otherwise indicated.

ISSUES

1. Whether the Service may impute interest, pursuant to section 482, on amounts due from the Taxpayer to related entities as a result of purchases in the ordinary course of business, where (1) the Taxpayer is not required to pay the amounts due by any specified date and (2) the Taxpayer is not required to pay any interest on the amounts due for the period during which the amounts are outstanding.

2. Whether the Taxpayer is liable for withholding tax, pursuant to sections 1442 and 1461, for interest imputed pursuant to section 482.

CONCLUSIONS

1. Yes. Pursuant to section 482, the Service is authorized to allocate income between the Taxpayer and the related entities in order to reflect an arm's length rate of interest for the use of the amounts outstanding. The Service may apply section 482, regardless of whether it also may apply to section 7872.

2. Yes. The Service takes the position that the Taxpayer need not make an actual payment of interest for section 1442 to apply.

FACTS

[redacted] (the "Taxpayer") is a California corporation wholly owned by [redacted] ("[redacted]"), a [redacted] corporation. Prior to [redacted], the Taxpayer used the fiscal year ending March 31 as its taxable year. As of April 1, [redacted], the Taxpayer uses a calendar year as its taxable year.

[redacted] is wholly owned by [redacted] ("[redacted]"), a [redacted] corporation, which in turn is wholly owned by [redacted] ("[redacted]"), another [redacted] corporation. It is our understanding that neither [redacted], [redacted], nor [redacted] conducted any trade or business within the United States during the years at issue.

The Taxpayer is a distributor of [redacted] products. The Taxpayer purchases more than [redacted] percent of its [redacted] products from foreign companies controlled by [redacted]. While the Taxpayer does assemble [redacted] to meet specific customer needs, you treat this activity as incidental to its primary business purpose, the distribution of [redacted] products in the United States, as well as typical for

distributors of [redacted]. Attached is a schedule showing accounts receivable due from and accounts payable due to [redacted] and its affiliates for the years at issue.

Although it is not specifically stated, it is our understanding that [redacted] and its affiliates did not set any terms for payment on the sale of their [redacted] products and did not charge any interest on the amounts owing from the Taxpayer.

The Taxpayer did not report any interest income associated with its accounts receivable nor any interest expense associated with its accounts payable on its U.S. Corporation Income Tax Return, Form 1120, for fiscal years ending March 31, [redacted] through March 31, [redacted] and short-year ending December 31, [redacted].

You propose to impute interest on the "overaged" accounts payable pursuant to section 482 and to impose a withholding tax pursuant to sections 881 and 1442 on such imputed interest. You, however, do not identify the amount of the proposed imputed interest or the amount of the proposed withholding tax liability.

The Taxpayer states that it is a common practice for companies like the Taxpayer "not to impose an interest charge on the trade payables between companies, when the U.S. affiliate owes bulk trade payables." Memorandum dated [redacted], from [redacted], the Taxpayer's counsel, to the Service, p. 1. The Taxpayer, however, has not provided any information supporting this contention.

DISCUSSION

I. APPLICATION OF SECTION 482

Section 482(a) authorizes the Service to distribute, apportion, or allocate gross income, deductions, credits, or allowances between controlled entities, if it determines that such distribution, apportionment, or allocation is necessary to prevent evasion of taxes or to clearly reflect the income of any of such controlled entities.

Specifically, the Service may make appropriate allocations to reflect an arm's length rate of interest for the use of funds, where one member of a controlled group makes an interest-free loan or a loan at less than an arm's length rate of interest to another member of the group. Treas. Reg. § 1.482-2(a)(1)(i). For this purpose, an indebtedness arising in the ordinary course of business from sales between members of the controlled group (an "intercompany trade receivable") is considered a loan between

members of a controlled group. Treas. Reg. § 1.482-2(a)(1)(ii)(A)(2).

The term "arm's length rate of interest" means a rate of interest which was charged, or would have been charged, at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances. Treas. Reg. § 1.482-2(a)(2). Treasury Regulation § 1.482-2(a)(2) provides "safe haven" interest rates based on the applicable Federal rate.[2]

As a general rule, the period for which interest is charged with respect to bona fide indebtedness between controlled entities begins on the day after the indebtedness arises and ends on the day that the indebtedness is satisfied (whether by payment, offset, cancellation, or otherwise). Treas. Reg. § 1.482-2(a)(1)(iii)(A). The period for which interest is charged with respect to an intercompany trade receivable, however:

1. begins on the first day of the third calendar month following the month in which the intercompany trade receivable arises, or,
2. in the case of a debtor which actively conducts its business outside the United States, begins on the first day of the fourth calendar month following the month in which the intercompany trade receivable arises, or,
3. where the credit or unrelated parties in the creditor's industry, as a regular trade practice, allow unrelated parties a longer period without charging interest than that described in (1) or (2) above, shall be such longer interest-free period.

Treas. Reg. §§ 1.482-2(a)(1)(iii)(B), (C), and (D).

In this case, the Taxpayer purchased [redacted] products from [redacted] and/or its affiliates and incurred an indebtedness associated with such purchases for which it was not charged any interest. This scenario falls squarely within the

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[2] Because the Taxpayer was not charged interest on its outstanding accounts payable, we do not find it necessary to discuss in detail the safe haven rates.

purview of section 482.[3] As such, you may impute interest to [redacted] and/or its affiliates on the amounts due from the Taxpayer pursuant to section 482 and the regulations thereunder. You, however, should keep in mind that the Taxpayer is entitled to an interest-free period of 60 to 90 days pursuant to Treasury Regulation § 1.482-2(a)(1)(iii)(B) or longer pursuant to Treasury Regulation § 1.482-2(a)(1)(iii)(D).

The Taxpayer argues that the Service may not impute interest on the overaged accounts payable. The Taxpayer relies on section 7872 and the regulations thereunder and Treasury Regulation § 1.482-2(a)(3) as support for this argument.

Application of Section 7872

We agree with the Taxpayer that section 7872 does not apply to the facts in this case. Treasury Regulation § 1.7872-5T(c)(2) provides that:

> section 7872 shall not apply to a below-market loan . . . if the lender is a foreign person and the borrower is a U.S. person unless the interest income imputed to the foreign lender . . . would be effectively connected with the conduct of a U.S. trade or business . . . and not exempt from U.S. income taxation under an applicable income tax treaty.

In this case, neither [redacted] nor the affiliates from whom the Taxpayer purchased its products conducted a trade or business within the United States during the years at issue.

But, as noted, you do not propose to impute interest on the overaged accounts payable pursuant to section 7872. You propose

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[3] Section 483 does not apply to the facts of this case. Generally, Section 483 applies to payments made under a contract for the sale of property, where all or part of the sales price is due more than 6 months after the date of sale and where some or all of the payments are due more than 1 year after the date of sale. Section 483, however, does not apply to below-market demand loans between a corporation and its shareholder. In this case, neither [redacted] nor its affiliates set a due date for payment on the purchase of the [redacted] products. The resulting accounts payable are akin to demand loans, and as such, are not subject to the rules of Section 483.

to impute interest pursuant to section 482. Therefore, it is not entirely clear why the Taxpayer focuses on this provision.

The application of section 482 is not dependent on the application of section 7872. The Service may impute interest under section 482, regardless of whether it also may apply section 7872. See Treas. Reg. § 1.482-2(a)(4) Ex. 3. If Congress had intended for section 7872 to override section 482 with respect to loans, it would have provided an exception to section 482 in the statute. And if the Treasury had interpreted section 7872 as overriding section 482, it would have included this interpretation in the regulations.

Moreover, section 482 addresses different concerns than section 7872. On the one hand, section 482 focuses on preventing the shift of income among controlled parties and placing controlled taxpayers on a tax parity with uncontrolled taxpayers by determining the true taxable income of the controlled taxpayers. On the other hand, section 7872 focuses on determining the substance of the transaction. Loans that fall within the purview of section 7872 are treated as two transactions, a loan to the borrower and an additional payment to the borrower. The additional payment may consist of a gift, dividend, capital contribution, or compensation.

Interpretation of Treasury Regulation § 1.482-2(a)(3)

We disagree with the Taxpayer's interpretation of Treasury Regulation § 1.482-2(a)(3). Treasury Regulation § 1.482-2(a)(3) states:

> If the stated rate of interest on the stated principal amount of a loan or advance between controlled entities is subject to adjustment under section 482 and is also subject to adjustment under any other section of the Internal Revenue Code (for example, section 467, 483, 1274, or 7872), section 482 and paragraph (a) of this section may be applied to such loan or advance in addition to such other Internal Revenue Code section.

It then provides the order in which the different provisions are applied.

> (i) First, the substance of the transaction shall be determined; for this purpose, all the relevant facts and circumstances shall be considered and any law

> or rule of law . . . may apply. Only the rate of interest with respect to the stated principal amount of the bona fide indebtedness (within the meaning of paragraph (a)(1) of this section), if any, shall be subject to adjustment under section 482, paragraph (a) of this section, and any other Internal Revenue Code section.
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> (ii) Second, the other Internal Revenue Code section shall be applied to the loan or advance to determine whether any amount other than stated interest is to be treated as interest, and if so, to determined such amount according to the provisions of such other Internal Revenue Code section.
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> (iii) Third, whether or not the other Internal Revenue Code section applies to adjust the amounts treated as interest under such loan or advance, section 482 and paragraph (a) of this section may then be applied by the district director to determine whether the rate of interest charged on the loan or advance, as adjusted by any other Code section, is greater or less than an arm's length rate of interest, and if so, to make appropriate allocations to reflect an arm's length rate of interest.
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> . . .

Treas. Reg. § 1.482-2(a)(3).

In interpreting this regulation, the Taxpayer takes sentences out of context and ignores completely portions of the ordering provision.

First, the Taxpayer focuses on the phrase "'**[o]nly the [stated] rate of interest with respect to the stated principal amount of the bona fide indebtedness** . . ., if any, shall be subject to adjustment under section 482 . . .'" Memorandum dated [redacted], from [redacted], the Taxpayer's counsel, to the Service, p.6 (quoting Treas. Reg. § 1.482-2(a)(3)(i)) (emphasis added by the Taxpayer). The Taxpayer then concludes that "there is no stated rate of interest applicable between the trade payables, since they were not and are not subject to interest payments."

The Taxpayer, however, does not consider the context in which that phrase appears. As stated above, before section 482 or any other section of the Internal Revenue Code can be applied, the substance of the transaction must be determined. See Treas. Reg. § 1.482-2(a)(3)(i). Section 482 and such other sections will only apply to the portion of the transaction treated as a bona fide indebtedness. Id. And the phrase on which the Taxpayer relies should not be given any greater meaning than that. See Treas. Reg. § 1.482-2(a)(4) Ex. 1; see also I.R.C. § 483 (section 483 applies to "total unstated interest").

Moreover, if we accept the Taxpayer's interpretation, sections 482, 483, 1274, and 7872, as well as Treasury Regulation § 1.482-2(a)(3), would not have any effect. All of these sections address situations in which the creditor has not charged any interest on the debt, has not charged an arm's length rate of interest, or has not specifically stated the interest rate on the debt instrument. Under the Taxpayer's theory, none of these sections can apply where the creditor does not charge any interest or does not state specifically the rate of interest on the debt interest, because there is no stated interest. This is clearly not the proper result.

Second, the Taxpayer ignores the third rule of the ordering provision which allows the district director to determine whether the rate of interest charged on the loan, as adjusted by any other Internal Revenue Code provisions, is an arm's length rate of interest pursuant to section 482. It is difficult to read the extra word used by the Taxpayer, "stated," into this provision. Again, if we accept the Taxpayer's interpretation, we reach an unusual result. That is, under Treas. Reg. § 1.482-2(a)(3)(iii), section 482 will apply if the creditor charges interest, but it will not apply if the creditor does not charge any interest. Again, this is clearly not the correct interpretation.

II. APPLICATION OF SECTIONS 881 AND 1442 TO IMPUTED INTEREST

Section 881 imposes a tax of 30 percent of the amount received from sources with the United States by a foreign corporation as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income, but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States.

Section 1442 provides that, in the case of foreign corporations, "there shall be deducted and withheld at the source in the same manner and on the same items of income as is provided

in section 1441 a tax equal to 30 percent thereof." Section 1441 requires all persons, in whatever capacity, having control, receipt, custody, disposal, or payment of any items of income specified in section 881 to deduct and withhold from such items a tax equal to 30 percent.

Section 1461 provides that every person required to deduct and withhold any tax under sections 1441 and 1442 is liable for such tax and is indemnified against the claims and demands of any person for the amount of any payments made in accordance with sections 1441 and 1442.

In this case, the Taxpayer has not made an actual payment of interest to the Parent. Arguably, however, the Taxpayer need not make an actual payment for sections 881, 1441 and 1442 to apply.

The Tax Court has held that section 881 does not require actual payment of the income item and that the allocation of income pursuant to section 482 provided a sufficient basis for imposing the tax under section 881. See Central de Gas de Chihuahua v. Commissioner, 102 T.C. 515 (1994).

The Tax Court, however, expressly did not reach the issue of whether there was a requirement for actual payment for purposes of sections 1441 and 1442. The Court distinguished between section 881, which imposes a liability for tax, and sections 1441 and 1442, which provides the means for collecting that tax, and noted that these sections served distinctly separate purposes. Nonetheless, we take the position that this case supports subjecting interest imputed under section 482 to the withholding requirements of sections 1441 and 1442. As stated above, the case stands for the proposition that an amount allocated under section 482 is deemed received by the foreign entity and is subject to tax under section 881. If sections 1441 and 1442 are the means to collect on this tax, the amount so allocated should be deemed received for their purposes. To find otherwise would render ineffective the liability imposed by section 881. The Tax Court touched on this concern when it observed that "[a] holding that actual payment is required could significantly undermine the effectiveness of § 482 where foreign corporations are involved. Such a view would permit such corporations to utilize property in the United States without payment for such use and thereby avoid any liability under § 881." Id. at 520.

In addition to Central de Gas, we look to two other cases in support of our position that actual payment is not needed for sections 1441 and 1442 to apply: Climaco and Nakamura v. Internal Revenue Service, 96-1 USTC ¶ 50,153 (E.D.N.Y. 1996) (unpublished opinion, Jan. 24, 1996) and Casa de la Jolla Park,

Inc. v. Commissioner, 94 T.C. 384 (1990). In Climaco, the District Court held that the plaintiffs were required to withhold and pay a portion of the interest imputed pursuant to section 7872 even though they did not actually make any interest payments on the loan. The court could not discern any reason why the plaintiffs should not be required to make withholding payments. Climaco, 96-1 USTC ¶ 50,153. In Casa de la Jolla, the Tax Court rejected the petitioner's argument that section 1441 requires actual payment and receipt, stating that the language of section 1441 "contemplates imposing responsibility on a broad spectrum of persons: 'all persons, in whatever capacity acting . . . having the control, receipt, custody, disposal, or payment.'" Casa de la Jolla, 94 T.C. at 392-393 (quoting section 1441(a)) (emphasis supplied).

Finally, we note that Treasury Regulation § 1.1441-2(e)(2) addresses the issue described above. Specifically, it provides:

> A payment is considered made to the extent income subject to withholding is allocated under section 482. Further, income arising as a result of a secondary adjustment made in conjunction with a reallocation of income under section 482 from a foreign person to a related U.S. person is considered paid to a foreign person .

Treas. Reg. § 1.1441-2(e)(2). While this regulation is effective only for payments made after December 31, 1999, and therefore, does not apply to the taxable years in this case, it does represent a position consistent with current applicable law on this point. Neither the preamble to the regulation nor the regulation itself indicates that the regulation was intended to reflect a change in the Service's position.

III. OTHER COMMENTS AND RECOMMENDATIONS

It is unclear how you propose to compute the interest adjustment pursuant to section 482. We, therefore, remind you that you must account for the interest-free period described in Treasury Regulation § 1.482-2(a)(1)(iii)(B). As stated above, interest is not required to be charged on an intercompany trade receivable until the first day of the third calendar month following the month in which the intercompany trade receivable arises. For example, interest on an intercompany trade receivable arising in [redacted] is not required to be charged until [redacted]. We recommend that you take the following steps:

1. determine the outstanding balance of accounts payable as of [redacted];
2. impute interest on this amount beginning on April 1, [redacted], the first day of the taxable year ending on March 31, [redacted];
3. determine the total purchases made for each month after [redacted];
4. impute interest on these amounts in accordance with Treas. Reg. § 1.482-2(a)(1)(iii)(B).

You also should account for any payments or credits, if any, as appropriate. Payments are applied against amounts outstanding in a first-in, first-out order. Treas. Reg. § 1.482-2(a)(1)(iv).

In its Memorandum dated [redacted], the Taxpayer indicated that it would provide you with "industry information" establishing that it is common practice for companies like the Taxpayer "not to impose an interest charge on the trade payables between companies, when the U.S. affiliate owes bulk trade payables." We advise you to scrutinize closely the information provided to you and ensure that the information reflects a creditor's practice in dealing with unrelated parties. As discussed above, Treasury Regulation § 1.482-2(a)(1)(iii)(D) provides an exception to the 90-day interest-free period only where the creditor or unrelated entities within the creditor's industry allow unrelated parties a longer period without charging interest. The Taxpayer's statement, however, refers to transactions between related parties.

Finally, you may wish to consider applying section 482 to impute interest income to the Taxpayer on "overaged" accounts receivable that do not offset accounts payable. For example, for the year ending March 31, [redacted], [redacted] owed the Taxpayer $[redacted] and was not owed any amount by the Taxpayer.

If you have any questions, please call the undersigned at (619) 557-6014.

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